DEPARTMENT OF STATE REVENUE

02-20050314.LOF

Page 1

LETTER OF FINDINGS NUMBER: 05-0314 Corporate Income Tax Tax Period: 2001 - 2003

NOTICE: Under <u>IC 4-22-7-7</u>, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Adjusted Gross Income Tax - Required Combination of Return

Authority: IC 6-3-2-2; IC 6-8.1-5-1(b); 45 IAC 3.1-1-62

The taxpayer protests the forced combination with its related corporations; taxpayer also protests the lack of credit given for previous payment of taxes.

II. Tax Administration - Interest

Authority: IC 6-8.1-10-1

The taxpayer argues that the interest was computed on the wrong amount.

III. Tax Administration - Ten Percent Negligence Penalty

Authority: IC 6-8.1-10-2.1; 45 IAC 15-11-2

The taxpayer protests the imposition of the negligence penalty.

STATEMENT OF FACTS

Taxpayer is an out-of-state company that is an operator of retail clothing stores and generates retail sales revenue through this operation. Taxpayer runs several of these retail stores throughout Indiana. Taxpayer has two affiliates, one of which is a distribution and merchandising center (Affiliate A) and the other is an administrative center (Affiliate B). Each of the entities is controlled by a parent corporation, which is an inactive Delaware holding company. Affiliates A and B perform tasks exclusively for the taxpayer. Each business is dependent on the other and were one to cease operations, the other two would essentially be rendered inert and ineffective.

An audit was conducted by the Department, which determined that taxpayer and its affiliates should be filing a combined return on a unitary basis. Taxpayer already files a combined return for state income tax purposes in several states, Indiana not being one of them. For federal income tax purposes, taxpayer files a consolidated income tax return. It was determined that if a unitary return was not filed, the amount of income attributable to Indiana would be distorted and would not fairly reflect the activities of the retail operation within Indiana.

As a result of the audit, the department assessed additional adjusted gross income tax, interest, and penalty. Taxpayer protested this assessment. A hearing was held and this Letter of Findings results.

I. Adjusted Gross Income Tax – Required Combination of Return DISCUSSION

As noted, taxpayer operates several retail clothing stores throughout Indiana, which generate substantial income. Affiliate A, the merchandising center, provides taxpayer with services that includes product merchandising and shipment of those products, for which taxpayer paid by means of transferring some of the income taxpayer earned in Indiana to Affiliate A as a form of compensation. Affiliate B, the administrative center, charged the taxpayer a fee for its support function. Taxpayer used the income it earned in Indiana to pay Affiliate B for its services as well. During the audit review of taxpayer's state corporate income tax returns, the Department concluded that taxpayer should have been filing a return on a combined basis reflecting taxpayer's own income and that of its related corporations. From the Audit Progress Report, the auditor commented that the two affiliates generate no sales or receipts, but that "a large percentage of the profits from the operations of the company as a total unit were in [the affiliates] that had been omitted from the Indiana filing."

Taxpayer disagrees with the decision requiring the combined reporting. Taxpayer contends that Affiliates A and B operate wholly within California and that taxpayer is the only entity doing business in Indiana. Taxpayer is of the opinion "that the default separate-entity filing method fairly represents income attributable to Indiana."

Taxpayer, in its letter dated July 29, 2005, states that the assessment "presents no evidence to support a finding that separate entity filing does not fairly represent Indiana income." It should be noted that under <u>IC 6-8.1-5-1(b)</u> it is the taxpayer, not the Department, that bears the burden of proof. Thus it is the taxpayer that has to present evidence that the assessment is invalid, as the assessment is prima facie correct.

The relevant statute is <u>IC 6-3-2-2(m)</u>, which states that in part (*Emphasis* added):

In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interest, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

In addition, IC 6-3-2-2(I) states (Emphasis added):

If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income

derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable;

- (1) separate accounting;
- (2) the exclusion of any one (1) or more of the factors;
- (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Taxpayer points to 45 IAC 3.1-1-62, which says in relevant part:

[T]he Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.

However, taxpayer offers insufficient proof that their filing methodology does not result in incongruous results. The auditor determined that their system does and will continue to produce incongruous results, and it is up to the taxpayer to prove otherwise.

(Taxpayer also invokes an earlier Letter of Findings (See L.O.F. 99-0659), stating that "Indiana has historically rejected taxpayer petitions for combined filings, even in situations where significant inter-entity transactions take place, arguing that combined filing is only allowed where 'it becomes impossible to accurately determine the Indiana source income attributable to the respective entities." Letters of Findings do not serve as precedent, and the taxpayer has not shown that its specific facts are similar to those dealt with in that L.O.F.)

The Department notes that the taxpayer already files on a unitary basis in several states, both as required by local law or voluntarily, as the case may be. In addition, taxpayer is being required by an increasing number of states to file a combined return. The same transactions between the three entities are occurring in these states; yet, taxpayer has not offered a compelling argument as to why it should not likewise file a combined return in Indiana.

Taxpayer and its affiliates effectively operated as one business with three separate legal entities, not as three separate unrelated businesses. Accordingly, if taxpayer and its affiliates earned their incomes as a combined, interrelated effort, not as entities operating in isolation, then that combined income – rather than taxpayer's separated income – was the true measure of the income of taxpayer's operations.

The Department agrees with the audit's conclusion that taxpayer and its affiliates should have been filing a combined return in an effort to more "fairly reflect" the group's Indiana corporate income. Pursuant to IC 6-8.1-5-1(b), taxpayer has failed to meet its burden of rebutting the presumption that the original audit decision was correct, and is thus denied regarding its protest of the combined return filing requirement.

The taxpayer also protests that the auditor neglected to apply taxes previously paid by the taxpayer for the 2003 tax year as an offset to the proposed audit assessments. Subject to audit review, the taxpayer is sustained on this issue.

FINDING

Taxpayer's protest of the combined return filing requirement is denied; subject to audit review, the taxpayer's protest regarding taxes previously paid by the taxpayer for the 2003 tax year as an offset is sustained.

II. Tax Administration – Interest

DISCUSSION

Taxpayer argues that the auditor improperly computed the interest "on the gross recomputed amount tax liability as shown on the AR-80s, rather than on the underpayment amount." The statute that deals with interest is IC 6-8.1-10-1, which states in part:

(a) If a person fails to file a return for any of the listed taxes, fails to pay the full amount of tax shown on the person's return by the due date for the return or the payment, or incurs a deficiency upon a determination by the department, the person is subject to interest on the nonpayment.

A review of the audit report and the subsequent AR-80's reveals that taxpayer's contention is incorrect.

FINDING

Taxpayer's protest is denied.

III. Tax Administration – Ten Percent Negligence Penalty DISCUSSION

The taxpayer protests the imposition of the ten percent negligence penalty pursuant to IC 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows: Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as

negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The taxpayer provided documentation to indicate that its failure to pay the assessed corporate income tax was due to reasonable cause rather than negligence.

FINDING

The taxpayer's protest to the imposition of penalty is sustained.

Posted: 11/01/2006 by Legislative Services Agency An httml version of this document.